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### Baron Point Research Message to Fed Chairman Powell: Remember the Alamo! September 1, 2022

Baron Point issue research describing current intermediate term trends and topics we find interesting. This research is intended to complement the regular Monthly Fact Sheets which include our monthly return updates.

A summary table of contents is shown below. **If you have any comments please feel free to email us at [info@baronpoint.com](mailto:info@baronpoint.com) or call +1 (212) 248-2733 x701.**

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## Message to Fed Chairman Powell: Remember the Alamo!

By Baron Point Financial with the Curmudgeon



Source: The Huntsville Item, Huntsville, Texas.



## Introduction:

We provide our perspective on the market sell-off on Friday, August 26, 2022, as well as update clients on various other topics we've discussed in the past with you.

## Friday's Markets Tank After Fed Speech:

Fed Chairman Jerome Powell is generally a moderate likable type of man, who speaks in words and tones that are well balanced and temperate.

Not at Jackson Hole, Wyoming last Friday!

In a 10-minute speech (some say it was only 8 minutes) at the annual **Jackson Hole Economic Symposium** on Friday, August 26, 2022, Fed Chairman Jerome Powell said returning the economy to price stability will take "some time" and will require bringing "some pain to households and businesses." He said that would be the "unfortunate costs of reducing inflation."

"We must keep at it until the job is done," Powell said. "Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance."

At 10:09am EDT on Friday, August 26, 2022, the S&P 500 was unchanged. The benchmark U.S. stock index then began a steady decline to close -3.37% lower on the day. Only four stocks in the S&P 500 rose while 43% of S&P stocks were down at least 4% on Friday. It was a total, across the board, sell off.

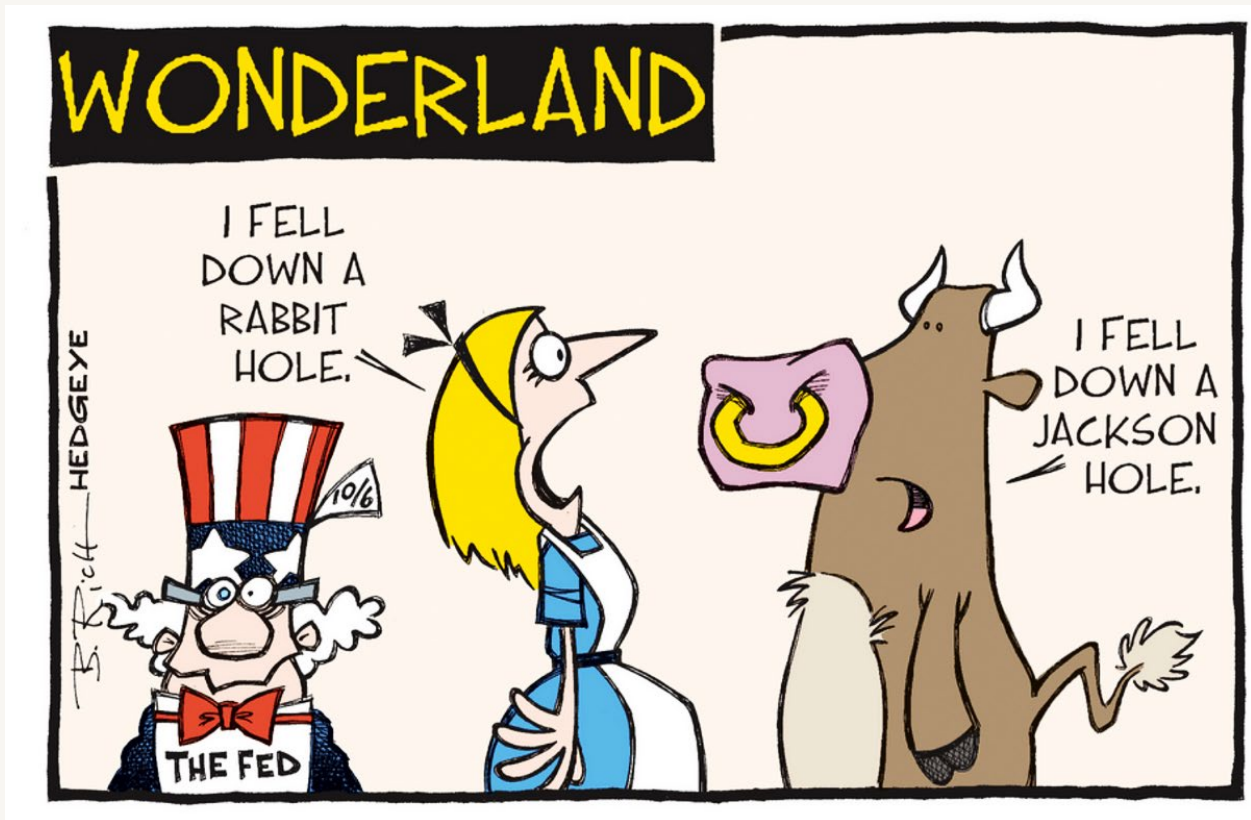
Other stock indexes had similar losses. The NASDAQ Composite slid 3.9%. The small cap Russell 2000 was down -3.30%.

Almost all other asset classes declined after Powell's speech. Bitcoin, corporate and high yield bonds, the 10-year T-note, REITs, Gold, and Silver also ended substantially lower.

As expected the U.S. dollar rose in a "flight to safety." A diversified, balanced portfolio did not help investors one bit on Friday!



Here's what stock market bulls had to say:



Source: Cartoon Courtesy of Hedgeye



## What Happened to the Fed Pivot?

For quite some time there's been talk of a “**Fed Pivot**” from raising short term interest rates (followed by a pause) and then lowering rates in 2023. Powell dispelled that notion in his Jackson Hole speech. “The historical record cautions strongly against prematurely loosening policy,” Powell said.

To understand the market mentality of looking for the Fed to “Pivot” we need to understand that over the last 13 years, **the Fed has trained equity investors and traders to be lemmings** which follow the Fed's talk and action rather than the real economy.

Previously, economists and financial analysts on Wall Street believed stock prices were primarily driven by earnings growth, which normally could not appreciably exceed real GDP.

This, however, has not been at all been the case since December 2008!

- Real GDP was US\$ 15,366.6 in December 2008. It increased to US\$ 19,727.8 on March 31, 2022. That equals a compounded growth rate of only 1.9%! (Note that Real GDP dropped in the last quarter, but the official numbers are not out yet so annual Real GDP growth will be lower).
- Meanwhile, the S&P 500 in the period from December 31, 2008, to July 31, 2022, compounded at 14.11%.
- This means the S&P 500 outperformed the “norm” by a whopping 12.21%, in the period from December 31, 2008, to July 31, 2022!
- Stated differently, as a result of the Fed's largesse, the S&P 500 outperformed the real economy by approximately EIGHT TIMES!

We believe strongly, this was mostly due to the Fed's QE and ZIRP, which injected unprecedented amounts of liquidity into financial markets, found its way into risk assets classes, such as the S&P500.

So, when Powell nixed the notion of a Fed Pivot on Friday at Jackson Hole, equity markets collapsed.



## Fed Has Tightened Beyond Raising Rates:

In addition to the rapid and large increases in the Fed Funds rate, the Fed has tightened credit in several other ways:

1. **M2 money supply (M2SL)** has barely budged this year. It was 21,649.6 billion on January 1, 2022 and was at 21,709.2 billion on August 23, 2022.

That's a 0.00257%, and this anemic growth of M2SL is depicted in this chart:



2. **Quantitative Tightening (QT):** On June 1, 2022, the Fed began a program of quantitative tightening (QT), reducing its balance sheet by US\$ 45 billion per month over the summer. It plans to accelerate the winding down to US\$ 90 billion per month starting September 1, 2022.

After the pandemic began, the Fed expanded its balance sheet by US\$ 4.8 trillion in 2020 and 2021. Equities rallied strongly as the Fed expanded its balance sheet which provided more than an ocean of liquidity for stocks, which have been declining this year as investors react tighter credit conditions.

3. **Reverse Repo's<sup>1</sup>**, which drain money from the financial system, now total US\$ 2.182 trillion (as of August 26, 2022). That's a decrease from its high of US\$ 2.271 trillion on July 21, 2022. When the Fed wants to ease, it will drastically allow the daily repos to mature which puts cash back into the banking system and the real economy.



<sup>1</sup> A **reverse repurchase agreement, or "reverse repo,"** is the purchase of securities with the agreement to sell them at a higher price at a specific future date.

### **Inflation Drops Due to Lower Gas Prices:**

Inflation has declined, mostly due to lower gas prices. On July 26, 2022, the Biden Administration announced that it was releasing the next Notice of Sale to supply additional barrels of crude oil from the **Strategic Petroleum Reserve (SPR)** onto the global market, building on the more than 125 million barrels of oil that have already been sold.

By using the nation's strategic oil reserve, U.S. gas prices (national average) have substantially decreased. On June 21, 2022, they were US\$ 4.97 a gallon for regular and diesel US\$ 5.81. On August 26, 2022, U.S. drivers paid US\$ 3.87 for regular and diesel US\$ 5.01 per gallon.

Consumer prices rose 6.3% in July from a year earlier, down from 6.8% in June, as measured by the **Commerce Department's personal-consumption expenditures (PCE)** price index which was reported on Friday. The **core PCE index**— which excludes volatile food and energy prices—increased 4.6% in July from a year ago, down from 4.8% in the year through June. On a monthly basis, core prices rose a seasonally adjusted 0.1%, slowing markedly from June's 0.6% pace.

### **Income Inequality Has Increased:**

The main beneficiary of 13 years of stock market gains have been the richest Americans. Those that do not own equities (~44% of the U.S. population) have not profited from the Fed's super easy monetary policy, which included four rounds of QE and holding the Fed Funds rate at zero (ZIRP) for exceptionally long periods of time.

According to Gallup, The wealthiest 10% of Americans hold 89% of stocks, worth US\$ 35.87 trillion. The top 1% of Americans (in terms of net worth) increased their ownership of stocks during the pandemic while the value of their stock holdings grew by US\$ 10 trillion.

Also, the Fed is owned by the richest families (whose names are a secret).



## Can the Fed Manipulate the Economy to Lower Inflation?

Since Powell admitted that inflation was NOT transitory on November 30, 2021, the Fed's balance sheet actually INCREASED by ~2.2%! So, the Fed was not really focused on curtailing inflation.

Now the Powell led Fed has reversed course with talk and actions that have caused financial markets to fall this year. The Fed believes that will cause a "reverse wealth effect" which will result in reduced consumer spending and smaller price increases.

*We're not sure if that will work, as the economy is not that easy to manipulate.*

*It is still our belief (as we do not trust a word the Fed says) that if new data indicates the U.S. economy is steeply declining, the Fed will not raise rates at its September 20-21, 2022, FOMC meeting.*

Conversely, if the economy holds up according to new U.S. government reported economic numbers, then the Fed may raise rates by 50 to 75 bps at that meeting. That would not be good for the economy and markets.

## Hawkish Fed Talk Continues:

Fed officials this past week said the U.S. central bank will aggressively raise short term interest rates towards 4%.

Cleveland Federal Reserve President Loretta Mester said that the Fed will move rates higher until there is compelling evidence that inflation is easing, adding that it's too soon to say whether price growth has peaked. "It's really premature to say inflation has peaked and that it's on a downward trend," she said in an interview on *Yahoo Finance*.

"We want it to be on a sustainable downward trend and I'm just going to need to see several more months of better inflation data to be able to even say that it's peaked." That was a repeat of comments made earlier in the day on *Bloomberg Television*, where she said, "rates would likely have to move **above 4%** and stay there for some time to see price growth decelerate."

As Mike Tyson once said, "Everyone has a plan 'till they get punched in the mouth." In this case, recession and large job losses substitute for the Iron Mike's classic slip, hook, and instantaneous punch to the mouth!

Investors have reacted negatively to the Fed's hawkish tone. They've pulled money from U.S. stock funds with US\$ 1.2 billion in net outflows in the period ended Wednesday, August 24, 2022, according to **Refinitiv Lipper** data. That's after a brief stretch of inflows in the first half of August 2022. All told, investors yanked US\$ 44.1 billion from equity funds in June and July showing a lack of confidence in



the recent bear market rally. Junk bond funds had more than US\$ 4 billion in net withdrawals this past week.

### **U.S. and Europe in Recession; China and Japan Slowing:**

We believe the U.S. economy is in recession and raising rates in a recession is like rubbing salt in a wound. Therefore, it is unsustainable, unless the Fed accepts a depression. We experienced a similar real-time experiment at the end of 1929, under President Herbert Hoover in America. The Fed raised rates in August 1929. Then, in June 1932, they raised United States tax rates across the board. By the end of the decade, geo-politics took over, and World War II was upon us in 1939.

It should be noted that all past recessions in America, had two consecutive declining quarters of real GDP. The U.S. has just experienced this, again, in the first half of 2022.

So, as the Biden Administration dismisses that thought of recession, we go back and read some Paul Samuelson, an American economist, who was the first American to win the Nobel Memorial Prize in Economic Sciences:

*“Economists have long defined a recession as a period in which real GDP declines for at least two consecutive quarters.”*

**Europe is also in recession**, and in April, UK energy prices rose 48% and are forecast to rise 80% in October. Germany is greatly dependent on Russia supplied natural gas, whose price has increased sharply while the supply has greatly decreased due to the war in Ukraine.

**China** and **Japanese** economies in are also declining rapidly:

- China’s economy could weaken even further this year after July 2022 data showed that the recovery in China is slowing down and as a housing market downturns further, plus COVID-19 related restrictions and disruptions continue, it could get worse for the Chinese people, and its knock-on effect to global GDP growth.
- Economists noted that falling real incomes in **Japan** will dampen household spending amid rising prices, and Japan's economic recovery still faces multiple headwinds.



### **Conclusions:**

The Fed is likely to cause something worse than a recession if they actually execute the rate increases they have been talking about. Financial markets would decline a lot more and Americans will be poorer.

We will soon see if the Fed is real or bluffing about large rate rises at the September 2022 FOMC meeting.

A message for Fed Chairman Powell, "Be careful what you wish for and remember the Alamo!"

Thanks for reading,



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